Armenia has had very low inflation (decreasing year after year) for almost 4 years, stable domestic currency, average level of budget deficit and GDP growth. This is considered proof that reforms are going in the right direction and financial stability has been achieved, an efficient market economy has been created and all preconditions for strong economic growth and investment flow to Armenia have been established. But what we see now in reality is strong economic stagnation, very low levels of investment activity, acute social problems and problems of poverty, which go contrary to what one of the major official macroeconomic indicators show - permanent GDP growth from year to year. (see Table below)

What are the reasons and how can the real economic situations be explained?

Armenia seems to implement reforms step-by-step as recommended by leading international financial institutions, but all it has in the plus, at this stage, is a number of macroeconomic indicators. What still remains unsettled (regarding only economic issues) are problems of mass unemployment, very low standards of living and purchasing power, huge foreign trade deficit, fast growing external debt, low foreign direct and portfolio investments, low investment activity, corruption, and many other issues. Actually, many economic problems in Armenia often have non-economic roots but in this article we will concentrate only on the economic causes.

To determine the reasons why reforms didn't bring the expected results, we need to understand what Armenia is nowadays, and to classify the root causes of the economic issues:

- Armenia is a country in transition. This makes Armenia a subject of comparative analysis with other transition countries, post-socialist countries and republics of the former Soviet Union. Countries in this group have many similar socio- economic issues and many of them have implemented reforms based on recommendations by international financial institutions.
- Unsettled historical and social issues for Armenians. Human, societal and state development as well as historical issues have a big impact on economic processes, and exist in contemporary Armenian society in the form of numerous stable and self-developing complexes, inefficient norms of behaviour and understanding both in Armenia, the Diaspora and between them.

The focus of this article is on the first aspect, which makes Armenia a part of a world in transition. However, the second aspect correlates strongly with the first, and is perhaps not less important in terms of understanding the reasons of negative political, social, economic and societal processes that take place in Armenia.

Economic reforms in transition countries can be divided into achievement of 5 major economic tasks:

- financial stabilization (low inflation and budget deficit, stable prices and exchange rate);
- liberalization of economy (prices, economic links, foreign trade);
- privatization;
- structural adjustment of the economy;
- acceptance of the reforms, new institutions by the society, and creation of new stable norms of behaviour.

These are all economic tasks, of which the first three can be reached in a short-term perspective while the last two points require a longer time frame and a much more detailed approach, because they deal with evolutional issues and changing of the mentality of people and their norms of behaviour - the last point is a very difficult process which can't be reached only by economic measures. It deals with political and social, as well as historical and cultural issues. The first three stages can be done based on some technical approach, while the last two deal with an adaptive approach towards problems.

The reforms in transition countries were implemented based on Washington Consensus principles (financial stabilization, liberalization and privatization), that was established by the IMF and USA economic elite in 1970s for Latin America countries that traditionally suffered from hyperinflation and huge budget deficits. It was concerned with the maximum deregulation of the economy and decreasing the role of the state to monetary and fiscal policies, their integration in world economic processes such as globalization and international organizations. Later on, those principles were accepted as a "guidebook for reformers" in many transition countries and implemented at different speeds and intensity.

The practice of the recent 3 years as well as financial crisis of the developing and transition economies in 1997-1999 has shown that this scheme does not cover the whole basket of economic problems and brings too many negative processes, disproportions in the economic development of these countries. It has clearly proved that many social-economic processes in transition countries are new and unique and not covered by existing economic theories and approaches.

In fact, the whole concept of reforms in transition countries was brought to a simplified scheme in which the first three stages should be achieved within a very short-term (shock-therapy) and after reaching financial stabilization, the second stage - stable economic growth would be automatically reached by the self-creation of efficient markets and institutions, and socially accepted norms of behaviour. The monetarists' hypotheses that efficient institutions must arise because of natural selection and that all institutions and society will be rational in their actions have not proven to be true.

The practice showed that inefficient development can be self-supporting, self-developing and stable, especially in those countries which stayed under communist regime for a longer time. The consequences of the economic reforms in these countries were unexpected by many experts, whatever guideline direction of the reform process you would look at, mostly because of a mixture of aims with instruments, and neglecting the transformation costs and institutional traps effect on the reforms. Let's numerate the most important of these:

The rush to bring the prices under control produced a system of mutual arrears and provoked a shift towards barter trading, which actually meant that a non-monetary economy took shape on a new basis. Attempts to change the tax-collecting system gave a boost to shadow economy development. The slackening of state control over cash flows – a measure expected to create a competitive economic environment – fueled corruption. Lowering inflation and stabilizing prices didn't bring the cost of capital down and more available to the real sector of economy. Decrease and tight control of the budget deficit didn't result in a growth-oriented structure of expenditures and stability in budget incomes, but to a simultaneous decrease in both of them. Creation of the most developed financial sector in transition countries only in some cases caused an essential effect on the real economy and lending to small and medium size enterprises in other cases was one of the primary reasons for financial crises and disproportions in economic development. Stability of domestic exchange rate doesn't bring about growth of domestic production and export, but rather to stagnation of the economy and an increase in the foreign trade deficit thus making foreign exchange rate a long-term hostage of stability of prices and low inflation targets. The "shock privatization" campaign, instead of producing efficient private property holders, gave birth to a great number of inefficient organizations, a decrease of activity and in many cases to plundering and selling of the assets of privatized objects. All these changes were accompanied by an unforeseen and uncommonly sharp production decline, dramatic increase in unemployment and sharp polarization of the income structure within society.

Many of these unexpected phenomena are known as institutional traps. They are responsible for the misfortune of the economic reforms in many transition countries, including Armenia. The analysis shows that the formation of transformation costs and institutional traps are major risks in any reform process, and avoidance of these traps is an urgent task during transition. Major institutional traps are barter, mutual arrears, tax evasion, and corruption. Transformation costs are increased through the linkage effect and can support an originally inefficient norm even when the coordination effect stops working. Once fallen into an institutional trap, the system chooses a non-efficient path of development, and with time, returning to efficient development may not make sense any longer. Moreover, a system with a prevalent efficient norm, if strongly disturbed (with the set of equilibria, however, remaining structurally unchanged), may fall into an institutional trap in which it will remain even after the disturbing factor is removed. This is the so-called "hysteresis effect", which is typical to all norm-forming processes, including those involving institutional traps.

Each institutional transformation should be preceded by efforts to forecast and forestall possible institutional traps. Such efforts should became part and parcel of preparations for any kind of reform. Transformation costs should be taken into account. The right choice of the rate and sequence of reforms, and wise industrial policy are prerequisites of institutional trap avoidance. But if a trap is formed, the task of breaking out of it turns out to be very difficult. Related theory hasto be developed yet. Standard temptation is the imposition of much harsher sanctions for deviation from socially efficient norms. Such strategy may imply considerable expenditures and is capable of generating even worse institutional traps. However it is quite possible that new reforms have to be conducted to get out of institutional traps. The measures should be directed to weaken coordination, linkage, and inertia effects supporting the traps, to increase their transaction costs, and to decrease transformation costs and transaction costs of efficient norms.

Experience with large-scale transformations reveal an important and specific aspect of macroeconomic policy in economies in transition. If market mechanism is well developed, macroeconomic policy influences mostly macroeconomic indicators such as exchange rate, inflation, or GDP. For a country with unstable institutional structures, macroeconomic impact is capable of altering that structure. In Armenia, the standard receipt for fighting inflation-tough monetary policy promoted the formation of institutional traps.

Macroeconomic Indicators	1995	1996	1997	1998	1999
GDP at constant prices (% change)	6.9	5.9	3.3	7.2	3.3
Consumer prices	176.7	18.8	13.8	8.7	0.6
Trade balance (US$ millions)	-403.4	-565.5	-660.8	-681.9	-611.1
Current account (% of GDP)	-37.5	-29.7	-27.8	-27.1	-20.4
Foreign Debt (% of GDP)	29.0	32.5	39.1	38.9	45.4
Foreign Reserves (months of imports)	1.8	2.3	3.0	3.6	4.2
Exchange Rate dram/USD (period average)	405.9	413.4	490.0	504.9	535.1
Interest Rates (%, annual rate)					
(*) 91-days Treasury Bill	37.9	45.1	52.9	44.6	53.8
(*) 3 months Banks Loans (in drams)		69.6	57.1	49.1	39.3
State Budget (% of GDP)					
(*) Deficit	11.0	9.3	4.7	3.7	5.2
(*) Revenues	17.8	15.1	16.4	18.5	20.2
(*) Expenditures	28.8	24.4	21.1	22.1	25.4